Investing In Real Estate

Presentation for:

City of Burlington

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Introduction

- Real estate offers bond-like properties
  - Like bonds, returns consist primarily of income plus some underlying appreciation

Pros	**Cons**
• Greater Appreciation Potential	• Economic Sensitivity
• Inflation Protection	• Liquidity
• Higher Yields	• Fees

- Portfolio Role
  - Provides higher return than bonds (historically)
  - Reduces portfolio volatility like bonds (historically)
  - Offers protection in rising interest rate environment

Real Estate Variations

- Common elements of institutional-quality core funds
  - Commingled vehicles
  - Broadly diversified by geography and property type
  - Benchmarked against the NCREIF ODCE
- Investment vehicles consist of
  - Commingled Trust
  - Private Partnerships
  - Public REITS
  - Non-exchange traded REITS
  - Separate Account
- Real estate risk varies by property quality (core, value-added, opportunistic)
- Real estate investment styles varies by leverage (usually 30%-70%)
- Can play multiple roles in a portfolio
  - Conservative (core/core+) acts as bond substitute, 4-6% return expectation
  - Riskier real estate may be return driver, 10%-12% return expectation

Private Investment Vehicles

- Commingled Trust (Open-end fund)
  - ➢ Not registered with the SEC
  - ➢ Liquidity dependent on the ability and willingness of the real estate company to meet redemption requests
  - ➢ Need to be an accredited investor
  - ➢ Low correlation to equity markets (historically)

- Private Real Estate (Closed-end fund)
  - ➢ Not registered with the SEC
  - ➢ Liquidity dependent on the term of the fund, typically 8 to 12 year lockup
  - ➢ Need to be an accredited investor
  - ➢ Low correlation to equity markets (historically)

Public Investment Vehicles

- Publicly Traded REITS
  - Registered with the SEC
  - Traded in public markets, highly liquid
  - Need not be an accredited investor
  - Easier access to capital through the public markets
  - High correlation to equity markets (historically)

- Non-Exchange Traded REITS
  - Registered with the SEC
  - Liquidity dependent on the ability and willingness of the real estate company to meet redemption requests
  - Need not be an accredited investor
  - Low correlation to equity markets (historically)

Real Estate Property Types

- Industrial
  - Moderate to high return volatility
  - Smaller initial investment and annual maintenance tends to dampen economic sensitivity relative to office.

- Multi-Family (Apartment)
  - Moderate return volatility
  - Returns are more stable than most other property types because of the minimal impact from the loss of a single tenant.

- Office
  - High return volatility
  - Returns tend to be highly sensitive to economic performance.

- Retail
  - Low return volatility
  - Returns tend to be more stable than that of offices due to longer leasing terms

Real Estate Property Types

- Hotels
  - Very high return volatility
  - Comprised of hotels, motels, casinos, bed and breakfasts, resorts, and vacation rentals.
  - Like multi-family with 1-day leases and high operating expense

- Self-Storage
  - Moderate return volatility
  - Self-storage space is characterized by low construction costs, resulting in low barriers to entry.

Historical Lease Durations

Source: Security Capital Research & Management

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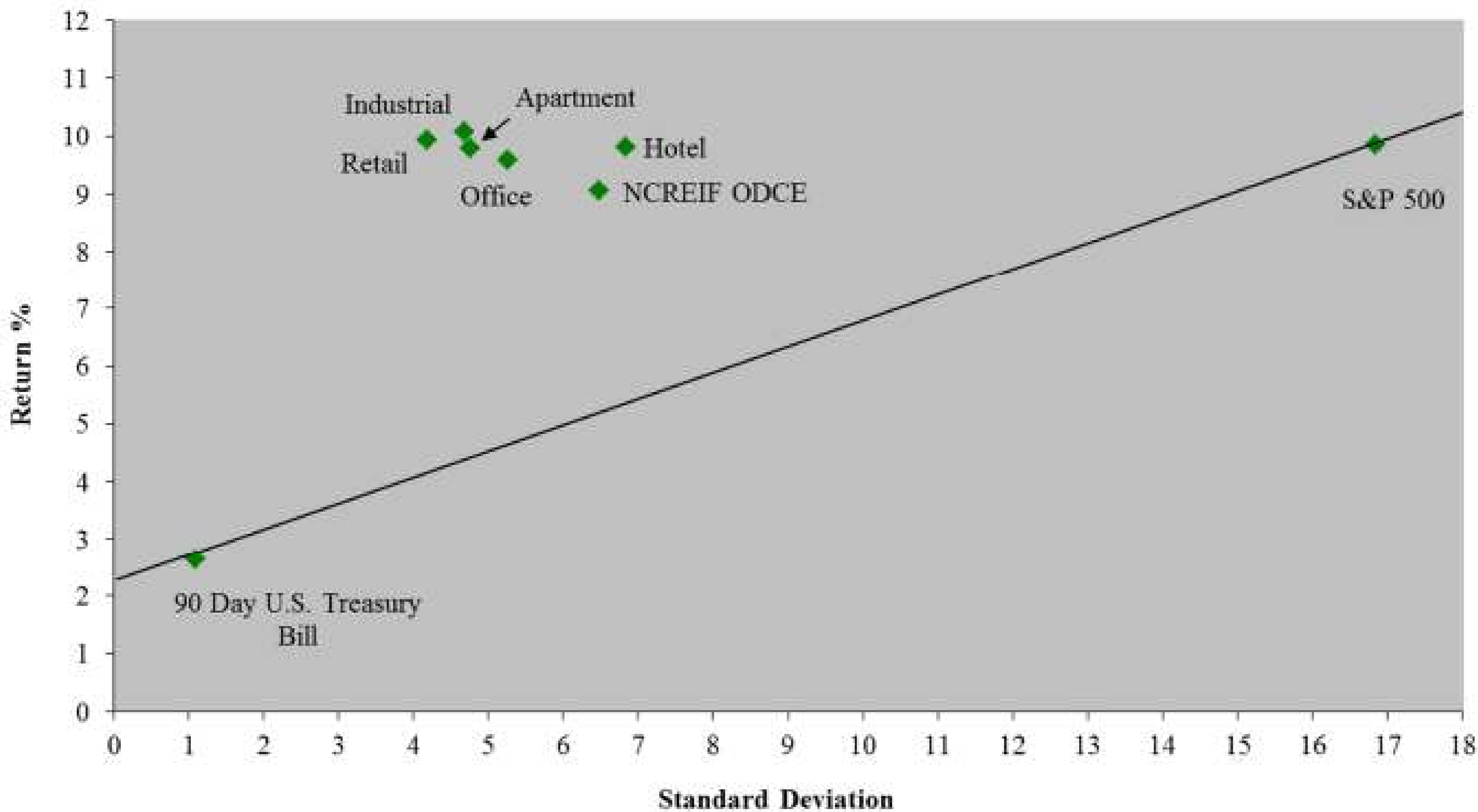
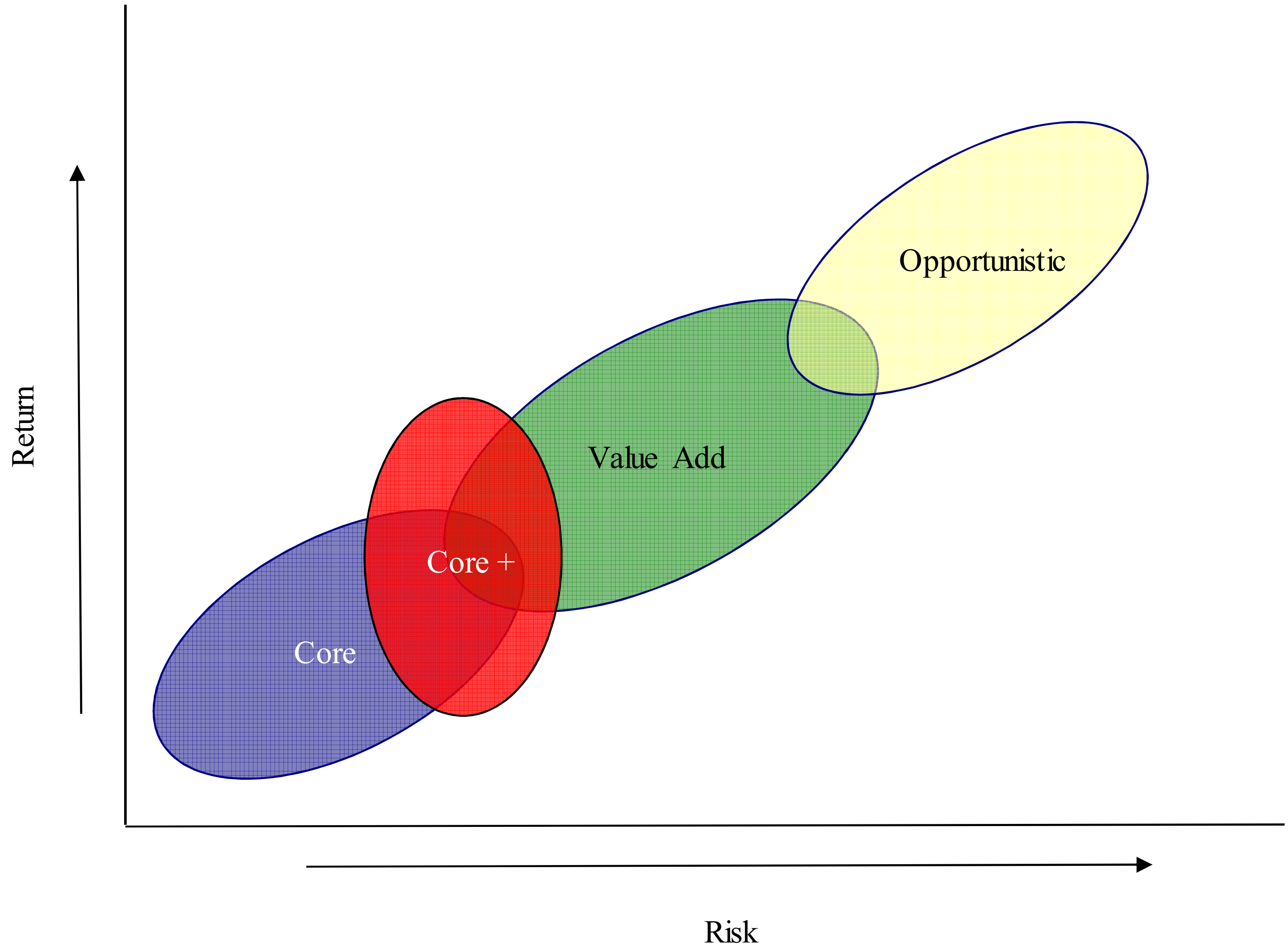
Risk and Return

NCREIF Index 20 years as of 12/31/14



Capital Market Line runs from the 90 Day U.S. Treasury Bill to the S&P 500

Real Estate Investment Styles



Real Estate Investment Styles

- Core
  - Target Net IRRs: 4-6%
  - Leverage Employed: up to 30%
  - Well diversified, low risk/return strategy
  - Buy and hold stabilized properties

- Core-Plus
  - Target Net IRRs: 7-9%
  - Leverage Employed: up to 55%
  - Moderate risk/return
  - Core type assets, some of which may require some from of value-add enhancement

- Value-Add
  - Target Net IRRs: 10-12%
  - Leverage Employed: up to 70%
  - Moderate to high risk/return strategy
  - Opportunity to add value through operation, re-leasing, and/or re-development

Real Estate Investment Styles

- Opportunistic
  - Target Net IRRs: >16%
  - Leverage Employed: over 70%
  - High risk/return
  - Re-positioning of poorly managed, obsolete, and/or vacant assets

- Mezzanine Lending/Distressed Debt
  - Target Net IRRs: 9-12%
  - Moderate risk/return
  - Acquires distressed loans from lenders at discount prices

- Fund-of-Funds
  - Target Net IRRs: 12-16%
  - Leverage employed: typically 0% at the fund level, but underlying mangers may use leverage
  - Low to high risk/return (Depending in the strategy selected)
  - Provides greater diversification through multi-manager approach

Historical Returns

- The expected total return lies between investment-grade fixed income and large cap equity
  - Historical returns have been between 5-10%.
  - 20-year return comparison through December 31, 2014:

S&P 500	9.85%
NCREIF ODCE	9.06%
BC Aggregate	6.20%

- High income potential, average annualized cash flow about 5.0%
- Historically low correlation to equity markets
- The ability to increase return in a diversified portfolio while reducing risk is the major appeal for real estate investing

Return-Correlation Comparison

Asset Class	Index	20-Year Return	Correlation
Large Cap Core	S&P 500	9.85	1.00
Small Cap Core	Russell 2000	9.63	0.90
International Equity	MSCI EAFE	5.02	0.86
Emerging Markets	MSCI EM	6.00	0.71
Fixed Income	Barclays Agg	6.20	-0.27
Real Estate	**NCREIF ODCE**	**9.06**	**0.18**
Timber	NCREIF Timber	8.05	0.04
Hedge Funds	Credit Suisse	9.18	0.68
Private Equity	Cambridge	14.96	0.76

*Results as of December 31, 2014; geometric mean.

Potential Inflation Hedge

- With the exception to the early Nineties when there was an oversupply of assets, real estate has proven to be an effective hedge against inflation.

    - **Short Run** - Real estate has lease provisions that acknowledge inflation and market rental rate movements

    - **Long Run** - Inflation increases nominal prices of labor and materials and as a result of this, increases the value of existing (through replacement cost valuations) and new properties

Impacts from Interest Rates

U.S. Economic Environment	Very Low Growth / Deflation	Moderate Growth / High Interest Rates	Moderate Growth / Gradually Rising Interest Rates	High Growth / Gradually Rising Interest Rates	High Growth / High Interest Rates
Probability Over Next 5-10 Years	Low	Moderately Low	Most Likely	Very Low	Moderately Low
Similar Periods	1930s, 2009: Japan 1990-present	Late 1970s / Early 1980s	1950s, early -2000s	1990s	1980s
Inflation Expectations	Negative	High	Moderate	Moderate	High
Outlook for Real Estate	**Least Favorable:** All real assets perform poorly in a deflationary environment	**Mixed:** Real estate provides an inflation hedge, but otherwise unimpressive returns	**Relatively Good**: Property income streams rise steadily, but not enough to induce a lot of development, and values increase roughly in-line with property incomes	**Outstanding:** Property incomes boom and capitalization rates stay low	**Mixed:** Property incomes provide current income, but not much capital return
Best Lease Lengths	Long-term with rent escalation clauses	Long-term with expense pass-throughs	Medium-term, to reduce volatility but also gain exposure to moderately rising rents	Short-term, to capture rising rents	Very short-term, to capture rising rents and offset high expenses
Best Markets	Gateway Markets	Broadly Diversified	Larger Markets	Secondary and tertiary markets	Broadly Diversified
Best Leverage Type	None	Fixed-rate	Fixed-rate now, floating-rate later	Either fixed or floating rate	Fixed-Rate

Source: American Realty Advisors and Dahab Associates

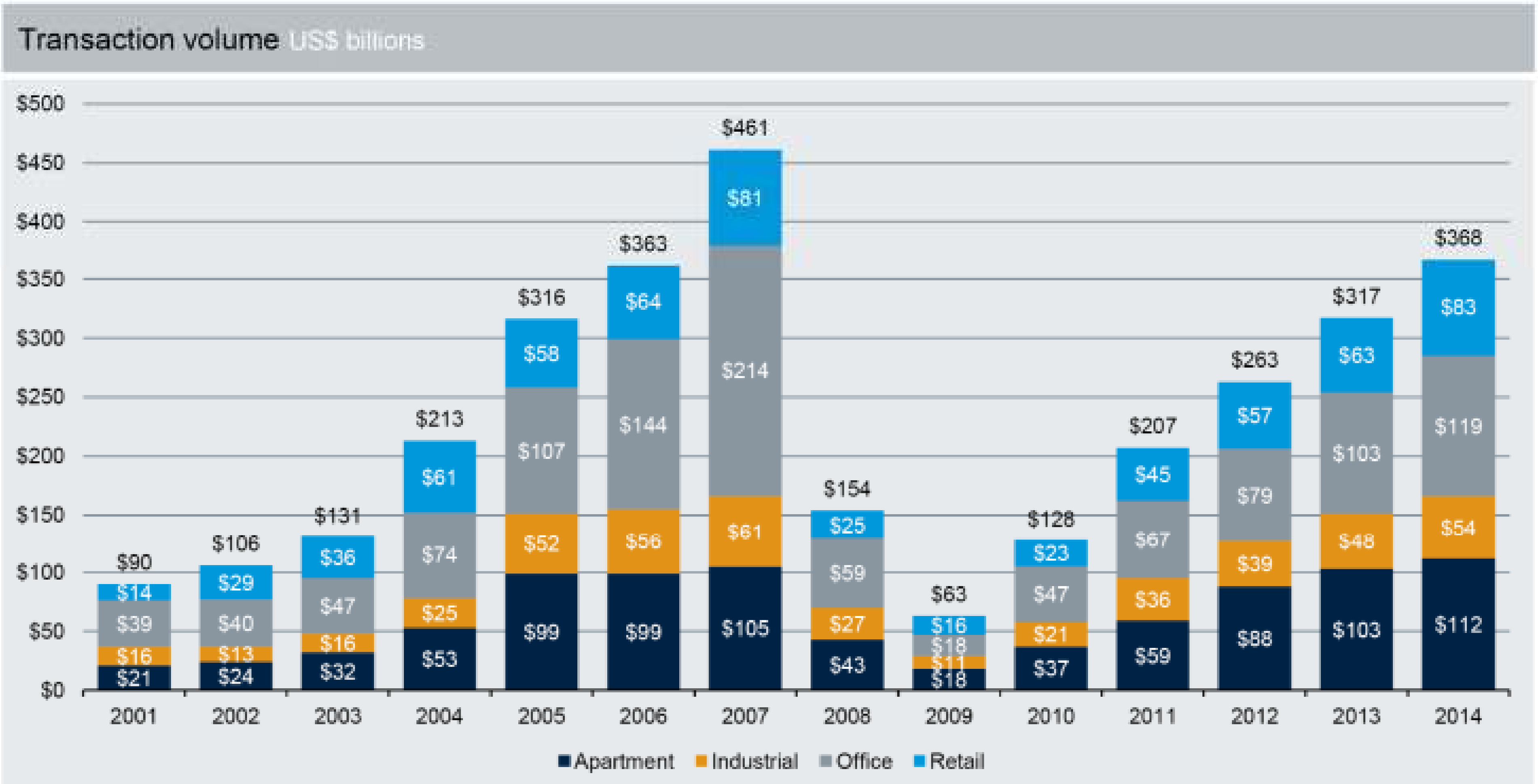
Commercial Real Estate Declines

1990 vs. 2009

- Key Similarities
  - Relaxed underwriting standards,
  - Excess capital
  - Steep increases in asset valuations

- Key Differences…
  - **1990 Real Estate Downturn**
    - Oversupply caused by tax incentives, deregulation of S&L industry
    - Duration of 7 years
  - **2009 Real Estate Downturn**
    - Driven by a lack of demand caused by the global recession
    - Oversupply not an issue most markets
    - Duration 2 years

Transaction Volume is picking up



Sources: Real Capital Analytics, Deutsche Bank

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Summary

- Real estate can play the role of a fixed income substitute, offering stable principal, an income stream, and low correlation to equity.
- Real estate continues to be a strategic part of the capital structure for institutional investors.
  - On average, institutional portfolios are 8.8% invested in real estate
- Real estate has advantages to bonds
  - Return and risk are between debt and equity
  - Values can rise in an inflationary environment
- Real estate is not a perfect substitute for fixed income
  - Real estate has suffered steep, but temporary declines twice since 1978
- Fees
  - Open-end funds

    Management fee on invested capital of 1%-1.3%; no carried interest
  - Closed-end funds

    Management fee on committed capital, 1%-2%; carried interest, 15%-30%